

Committee of European Banking  
Supervisors

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12<sup>th</sup> February 2008

Dear Sir

**Re: Response to the Second Consultation Paper on CEBS' Technical Advice to The European Commission on The Review of The Large Exposure Rules.**

It has not been the usual practice of this Bank to formally respond to regulators Consultation Papers preferring instead to rely upon responses provided by industry trade associations (such as the British Bankers Association - BBA). Where we consider it to be relevant we will make opinions available to such associations so that we can contribute to the debate.

However because of the direct potential impact upon this Bank that would follow should your recommendations come to fruition we feel it important that we make direct representation to you.

Outside of this specific response we have been in dialogue with the BBA regarding the response that they will be making on behalf of their membership and we should point out that we are very much in accord with their views.

Our response only deals with those specific issues and resulting questions that will have the greatest impact upon us and in relation to which we have concerns. We do not intend responding to all of questions raised by CEBS.

**1. Background**

Bank Leumi (UK) plc [BLUK] is a UK registered Bank authorised and regulated by the Financial Services Authority [FSA]. We are one of the largest overseas subsidiaries of the

much larger Bank Leumi Group, our direct parent company being Bank Leumi le-Israel B.M. [BLITA] a company established in the State of Israel.

BLUK has its Head Office in London and is itself the parent of a sub-group within which there are three main trading subsidiaries:

- Bank Leumi (Jersey) Limited [BLJ] (a Bank regulated by the Jersey Financial Services [JFSC]. It is also authorised and regulated by the FSA to undertake regulated mortgage activity).
- Leumi Overseas Trust Corporation Limited (a trust services company, also regulated by the JFSC).
- Leumi ABL Ltd [LABL], an invoice discounting and factoring business based in Brighton.

In the UK we provide commercial loans to businesses in a variety of niche sectors, and provide private banking facilities typically to higher net worth individuals and entities. We have permission to accept deposits, undertake regulated mortgage business and provide regulated investment services.

## **2. Response**

In the main our concerns relate to two areas, inter-group exposures and inter-bank exposures. We are concerned that the effect that further restrictions on exposures for these types of counterparties would have a detrimental effect upon our business model. It would also potentially increase our credit risk exposure particularly in the case of exposures to other financial institutions.

We also believe that your cost/benefit and market failure analysis have been conducted at a macro level without sufficient regard to micro issues such as the impact that your proposals would have on the small banks community. We are of the view that the smaller banks offer diversification of services to the public yet as a group they are likely to be more acutely affected by these proposals than their larger competitors to the point that they will be required to increase credit risk exposure, be exposed to greater cost, and in extreme cases be forced to amend their business models or reduce the level of their activities.

It is also fair to say that we believe if your analysis dealt with instances of failure within the small banks sector there would have a different result. From our knowledge of the UK market, many small banks typically carry more capital than the regulatory requirement in order to achieve market recognition and we believe there have been very few failures of small banks in recent years.

## **3. Inter-group Exposures**

We have several forms of intergroup exposure which fall into two distinct baskets:

- BLUK has its own Dealing Room which provides day to day treasury services for itself and for its own direct subsidiaries which includes any required funding.

LABL is funded by BLUK principally by way of debt. LABL is currently solo-consolidated and as such exposures to it are exempt from the LE limits. We note that under your proposals this situation is likely to remain.

In relation to our Jersey based subsidiary BLJ however the position is very different. BLJ's customer deposits comfortably exceed its lending activities. As a result they are long of funds and are net placers into the money markets albeit via ourselves. However on an individual currency basis they may require short term funding to avoid the need for foreign exchange swap management. BLUK therefore provides cash advances which in the majority of cases are of a short term nature. Exposures of this nature currently benefit from treasury concession arrangements.

- We also have exposures to our Parent Company and to certain of its other subsidiaries, our sister companies.

Clients of the Bank Leumi Group can be internationally based and/or active. Accordingly part of our activities incorporates providing credit facilities to clients of the group who are looking to establish or expand business in the UK or Europe. We therefore face situations of start up businesses where we often agree to provide credit facilities but only if supported by the guarantee of our parent company. BLITA are able to provide such guarantees because they are secured by a much stronger covenant or by directly taken collateral. At the present time we benefit from a parental guarantee concession that allows us to rely on such guarantees to the extent that as a result our exposure to the Group exceeds 25% of our capital resources.

There are occasions where BLITA are required to issue letters of credit or guarantees into territories, or to counterparties, where for political reasons they prefer to have such instruments issued by a UK or a European Bank. All such instruments are issued to support an underlying commercial transaction. In order to allow them to meet the requirements of their clients, and as we are a UK Bank, we issue these instruments in our name but on behalf of and at the risk of our Parent.

We have seen an increasing trend for internationally active Israeli businesses to raise public money in their domestic market in order to fund their international expansion (often into Europe). Raising Israeli Shekels creates a potential interest rate and currency exposure. We are asked to provide cross currency interest rate swaps. As one side of the interest rate swap is based on Israeli CPI we use our parent as the counterparty to hedge our exposure to our client.

Finally we do provide short term money market advances to our sister companies.

All intergroup activity is conducted at arms length.

### **3.1 Impact on BLUK**

The proposals as we understand them may result in the removal of both the Treasury Concession, and Parental Guarantee Concession which will have direct consequences on us:

- In relation to BLJ the removal of the Treasury Concession treatment could result in a restriction in the level of exposures that we could undertake with our Parent Company as any exposure to BLJ would then have to be included in total group exposure.

To avoid this problem BLJ may need to set up their own treasury operation and establish their own bank lines which would have cost implications for them. This may require them to:

Seek alternate funding from the money markets;

establish their own bank limits and relationships with counterparty banks and place surplus funds with those counterparties;

possibly establish their own currency swap management facilities.

All of the above would have cost implications. They would be unable to obtain funding at interest rates we could offer. The size of surplus funds that they have is far smaller than ours, and the size of individual placements inevitably would not be so attractive to the market and they would not be able to attract the same rates of interest that we are able to do. There would also be an increased operational risk for our subsidiary and therefore indirectly for us.

- In relation to BLITA the main impact would arise from removal of the Parent Guarantee Concession and the resulting restriction on the size of exposure we could take. This would mean that we would have to enter into fewer contingent commitments on behalf of our parent who would then have to issue instruments via other institutions. Our ability to provide our sister subsidiaries with funding (already restricted by the need to provide contingent liabilities on behalf of our parent) would no longer be something we could entertain. It would also restrict our ability to provide credit facilities to certain group clients who would need to seek such facilities from our local competitors.

### **3.2 Suggested Treatment**

We do not have an issue with the principle of restricting inter-group exposures, but in the main such exposures from our perspective are not in the main provided in the form of cash or money market loans or to satisfy our counterparty's liquidity requirements. Our requirement to exceed a 25% capital limit is directly related to those exposures that result from specific client initiated transactions which we undertake as a result of the strength of our Parent's covenant (in the form of a parental guarantee), or transactions undertaken on behalf of our parent and which are of a contingent nature.

The current concessionary approach seems to us to be a sensible one to retain as it allows regulators to maintain control of Large Exposures in a general context, but also allows them some flexibility but only in specifically restricted circumstances.

#### **4. Inter-Bank Exposures**

BLUK is in the fortunate position whereby the level of its customer deposits has historically exceeded customer lending and as a result we are typically long of funds which we place in the short term money markets.

This is particularly the case in US Dollars. On an average basis, after undertaking currency swaps to balance our sterling banking book, we place in excess of US\$400m into the markets at any one time. Commonly funds are placed on mainly an overnight basis, but placements can be for up to three months.

The short term nature of our placements means that we have to select those institutions with whom we have a relationship, and who for the size and duration of our individual placements are prepared to pay a reasonable rate for our funds.

For credit risk management purposes we obviously prefer to place funds with the larger banking institutions that benefit from a strong credit rating and there are approximately a little over twenty institutions that we commonly place funds with. On a daily basis we may use half of this number.

In order to achieve some diversification we already have to make some sacrifice in the credit standing of our counterparties as the 'triple A' banks will not quote prices except for very large sums especially in the case of overnight placements. We therefore face a balance of taking acceptable credit risk exposure on the one hand, but needing to be able to place funds in parcels of meaningful sizes in order to achieve good rates of interest.

Of the twenty or so counterparties used we have internally sanctioned lines that exceed 25% of our capital resources for the majority of them. Obviously because of the duration of the placements these exposures currently fall under the exempt definition.

We are therefore concerned that a removal of this exemption would have significant implications in the way in which we place funds into the market.

These effects will be further influenced by the fact we have other institutional exposures arising both from foreign exchange trading, and longer term exposures where the Bank may purchase a fixed/floating rate income instrument. In this regard we commonly have £120m invested in Eurobonds issued by banking institutions. We again select institutions with a strong credit rating which may have the effect of increasing exposures to those institutions with whom we are placing money market funds, albeit within internally sanctioned limits. It goes without saying that longer term exposures are kept well within the 25% threshold.

#### **4.1 Cost Benefit Analysis**

It seems that your cost/benefit analysis is heavily premised on the assumption that firms will be able to either diversify away or collateralise their exposures. We believe these assumptions to be flawed particularly in relation to the small banks community. Diversification may be achieved but only at the expense of taking significant additional credit risk exposure which we do not believe would necessarily be in our best interest.

Collateralisation is simply not an option available for small banks. We really cannot foresee a situation whereby in placing funds, on a short term money market basis, especially with the likes of an HSBC that counterparties will agree to provide us with collateral. We believe that the relative size of deposits that we make, although large in relation to our capital resources is small in relation to their funding requirements as a whole. There is therefore no probability that they are likely to collateralise our funds placement.

#### **4.2 Market Failure Analysis**

Your argument appears to be premised on the basis that almost every failure of a bank can be attributed to unforeseen risk. We do not necessarily agree with this view as we believe that such a general argument really undermines the risk management techniques that we are encouraged to implement and develop as part of the requirements of the Capital Requirements Directive. It particularly gives little credence to credit vetting or reputational considerations which we undertake as part of the risk assessment process.

We also do not agree that the bank failures you have highlighted support your view. Taking two of the examples as a case in point, long before their collapse, BCCI had a certain 'negative reputation' amongst the market place.

A more topical example is Northern Rock. This was an institution that we had in the past placed funds with and we had internally approved lines for such purpose. Through our credit assessment monitoring process, when the money markets first started to become volatile, as a result of the profile of their funding requirements, we foresaw that they could be heavily exposed to interest rate miss-match. As a result we removed our internally sanctioned limits to ensure that no further funds would be placed with them. We would

argue therefore that whilst the extreme effects of the issues of Northern Rock were not totally predicted, neither were the problems totally unforeseen.

### 4.3 Impact Upon BLUK

The potential removal of exempt inter-bank exposures would have several effects on this Bank.

- As previously explained when we lend funds to larger institutions we have to draw the balance in terms of risk and reward. Removal of exempt exposures will have the result that we will be forced to place smaller sized deposits into the market than is currently the case. Our relationship with the larger firms will suffer as the smaller the size of placements, the less interested in taking our funds they will become.

Inevitably this would mean having to reduce the credit quality of counterparties as we would have to place funds with smaller institutions of a weaker credit rating. Whilst this may indeed reduce concentration risk it would do so at the expense of taking additional counterparty credit risk, a situation that seems diametrically opposed to the objectives of the Capital Requirements Directive. It may well have forced us to actually deposit funds with the likes of a 'Northern Rock'.

Credit assessment is a fundamental discipline and mitigant in the process of taking any credit exposure. Whilst CEBS believes that credit quality should be disregarded in terms of controlling Large Exposures, forcing institutions to expose themselves to greater counterparty credit quality risk than they would otherwise choose to do undermines the whole philosophy of credit risk management and should not therefore be totally disregarded as you suggest. Lending more to a strong counterparty is not necessarily a greater risk than lending less to a weaker one.

- Where smaller placements are accepted there will inevitably be cost implications in that we would not necessarily receive the same rates of interest and this would have an effect on our pricing of deposit rates for our clients. This could lead us to becoming uncompetitive in the market place and to a risk of losing business.
- In moving to exposures with lower rated firms, this could potentially have capital adequacy implications, as obviously the lower the external credit rating potentially the higher the risk weight for regulatory capital purposes. Again a move that appears opposed with the objectives of the Capital Requirements Directive.
- Finally we make up to ten placements a day. If we were to be required to reduce the size of individual placements the number of counterparties used daily would increase as would the number of individual placements. This would have potential higher operational risk implications through managing an increased number of daily placements.

#### 4.4 Suggested Treatment

We understand that CEBS views the need to use the large exposure regime as a means of tackling the potential for unforeseen risk to create systemic failure, and for that reason seek the need for a backstop limit. We support the need for a backstop position but one that takes account of proportionality, and the specific effects that the proposal will have on the small banks community. We also believe that duration is a key factor in assessing risk exposure and maintaining some form of exemption for shorter term lending remains a valid position. We would therefore suggest the following:

- Ideally we would prefer the present twelve month duration exemption to remain in force. We believe that this takes account of the reduced risk arising from the type of money market business that we have described. If further controls are felt to be necessary we would advocate a return to the no-objection system. Until the implementation of the Capital Requirements Directive our regulator had the option to object to exempt exposures. In this way they were able to allow exposures above the 25% threshold but were able to monitor and control exposures that fell into the exempt category. On a systemic basis we believe that this was a sensible control and would suggest that this be re-introduced to allow continuance of the current exempt exposure principle.
- If a single backstop limit is felt to be unavoidable, we would advocate a 'carve out' de-minimus figure below which the 25% rule would not apply. In this way the small banks that are at most risk would not be as acutely affected, and any backstop limit aligned to capital would not assist some of the very small institutions. We would therefore support a regime which advocated that inter-bank exposures of up to twelve months duration, and below the level of £50m, should be exempt.
- If a backstop limit as a percentage of capital is felt to be unavoidable then we would support that inter-bank exposures up to twelve months duration should be limited to 75% of a banks capital resources requirement.

We thank you for your consideration of the above.

Yours sincerely,



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**Risk Control Manager**

CC: John Thorp  
British Bankers Association